Global imbalances: common problem to solve for both advanced and emerging market economies

Sergey IGNATIEV
Chairman
Bank of Russia

The recent crisis has shown that in order to enhance financial stability the international community should not only remove deficiencies in the regulation of financial institutions and markets, but also find a durable solution to the problem of global imbalances. The initial result of the financial crisis and economic recession was the lessening of global imbalances, including the reduction of the current account deficits and surpluses in the leading trading nations and moderate growth in the savings rate in advanced economies. In the future, however, unless productive measures are taken, the post-crisis global economy with unprecedentedly big public debt in many systemically important countries may again face the perils of global imbalances such as currency wars, protectionist pressures and financial instability.

Solutions to this problem are as varied as its causes and call for coordinated actions by both the developed and developing countries. In addition to the adjustment of the macroeconomic and exchange rate policies, there is a need to proceed with structural reforms aimed at raising the savings rate in the advanced economies and stimulating domestically driven growth in the emerging market countries. Taking into account the persisting precautionary motives for many developing economies with volatile capital account to hold sizeable international reserves, the development of a fair global financial safety net within the reform of the international financial infrastructure alongside with the strengthening of the national financial systems will play an important role in restoring balanced global growth.

NB: Alexey Ulyukaev, First Deputy Chairman of the Bank of Russia; Vladimir Smenkovskiy, Adviser to the Chairman of the Bank of Russia and Elizaveta Danilova, Chief Economist, Market Opérations Department, co-authored this article with Chairman Ignatiev.

Restoring global current account balance, distorted during the past decade, is a top priority for the international community focused on ensuring sustainable long-term economic growth. Global imbalances have created formidable problems for the world economy, as they provoked excessive decline in long-term real interest rates and surge in high-risk lending on the global scale thus becoming one of the most important reasons for the world financial crisis. For several years prior to the crisis ample liquidity and low cost of financing had stimulated ineffective allocation of world resources, maintained an excessive level of consumption in many countries, created asset price bubbles and led to growth in foreign and domestic debt.

In the years preceding the crisis many economists had warned about the threats of the growing imbalances in the trade and capital flows among the world's leading economies, especially the exorbitant current account deficit in the United States and current account surplus in China caused by excessive savings in the developing countries and excessive consumption in the developed nations. Many believed that a crisis could break out if global investors suddenly stopped buying US debt securities, compensating for the growing US current account deficit, and this would seriously hurt the US economy and affect aggregate global demand. However, the trouble came from where it was least expected, the US mortgage market, while the low-risk dollar-denominated assets not only remained attractive, but became a 'safe haven' for the investors who withdrew their funds from the riskier emerging markets.

As the crisis evolved, the local problem of one market, although the world's largest one, created by the poor quality of subprime mortgage loans and the perils inherent in securitisation, provoked a major financial crisis and the financial markets became virtually paralysed. The contagion of the crisis spread all over the world because in the pre-crisis years most investors failed to adequately assess their risks and there were numerous drawbacks in the regulation and supervision of the financial institutions and markets.

Imbalances in the global economy created conditions that encouraged banks and other investors to take excessive risks before the crisis and they may destabilise the world financial system in the future, too. More stringent regulation and new restrictions imposed on the banking sector in the leading economies will motivate banks to look for new markets and new instruments with higher returns. Thus, to prevent new crises or minimise their consequences, the world community should not only reform regulation, tightening capital and liquidity requirements for banks, upgrading the financial infrastructure and tackling the problem of the systemically important financial institutions, but also address the problem of global imbalances.

1| Causes of global imbalances

Global imbalances are a complex problem, a peculiar vicious circle created by both the developed and developing countries. On the one hand, imbalances are the result of the deficiencies in macroeconomic policies implemented by the advanced economies in the pre-crisis period. For a long time their monetary policy was too accommodative; it focused too much on consumer price index dynamics and ignored some important indicators of potential threats to financial stability, such as asset and commodity prices. Even when the Federal Reserve's target rate began to rise in the second half of the 2000s, US long-term interest rates remained unchanged. That extremely unusual situation largely resulted from the increased global imbalances: as trade surpluses grew, the developing exporting countries accumulated international reserves and invested these funds in US Treasury securities. Given the persistence of excess liquidity and low cost of resources, banks did not hesitate to take high risks and thus contributed to financial instability.

In addition, the developed countries' commitment to long-term fiscal consolidation amid rapid economic growth was insufficient in the pre-crisis years. Most of them in fact continued to pursue a procyclical fiscal policy, which also stimulated excessive consumption. They failed to take advantage of growth in tax revenues from the booming housing, construction and financial services sectors for reaching budget surpluses. Therefore, when tax revenues fell sharply during the crisis, the vulnerability of the fiscal sectors of these countries became apparent.

On the other hand, imbalances were partly caused by the policy pursued by certain developing countries, which stimulated exports and economic growth by undervaluing their currencies. That led to significant growth in their gold and foreign exchange reserves, although one should admit that there are also objective factors behind the trade and current account imbalances of different countries.

Furthermore, there was another rationale behind the excessive propensity for savings of some of the emerging economies that accumulated significant gold and foreign exchange reserves –the desire to create a security buffer against possible external shocks, which is the aftermath of the regional financial crises of the 1990s. This group of countries includes Russia. These countries are characterised by high capital and financial account volatility, massive inflow of speculative capital (which can quickly flee the country as soon as the first shock emerges), heavy dependence on exports and volatile markets and relative weakness of the financial system. The accumulation of reserves is the objective necessity for these countries as there are no adequate and predictable lending arrangements in the international financial institutions providing guaranteed access to credit in the required volumes.

The empirical models analysing the unprecedented growth in reserves over the past decade are based on this very rationale in the behaviour of developing countries. One of the early suggestions on this issue is the Guidotti-Greenspan rule elaborated after the crisis of 1997-1998 stating that a country's reserves should cover at least its short-term foreign debt. According to the latest models of international reserves build-up (O. Jeanne)[1], a country defines its optimal amount of reserves, comparing potential crisis costs (capital flight and decline in output) with the opportunity cost of keeping reserves (instead of making more profitable investments). Analysing model predictions for Asian countries, the author comes to the conclusion that the level of their reserves is justified if the expected crisis loss exceeds 60% of gross domestic product (GDP), whereas, according to the author's estimate, the expected loss from the contraction of capital inflow approximates 10-15% of GDP. Nevertheless, many countries especially susceptible to the risk of capital outflow may face considerably bigger loss as a consequence of a major crisis. For example, as a result of the 997-1998 crisis Korea and Malaysia sustained indirect losses (the difference between the actual and potential GDP growth rates in the post-crisis years) equalling about 50% of GDP (IMF estimate).[2]

In case of a crisis, reserves may be channelled to repay the foreign debt of the government, banks and companies with government interest, secure imports and support the domestic currency rate which will help minimise the negative consequences of the crisis for the economy. The experience of Russia confirms this well: during the latest crisis we had to use a substantial portion of our reserves to maintain financial stability and minimise the shock effect of the crisis for the businesses and households. Thanks to controlled and gradual devaluation of the rouble, public confidence in the national currency and banking system was preserved. Since August 2008 the deepest fall of the RUR/USD exchange rate during the crisis equalled 48%, while the capital outflow in the period from 2008 Q3 to 2009 Q1 amounted to USD 195 billion. If Russia had not had enough reserves, the rouble's fall would have been more dramatic and its consequences for financial and macroeconomic stability would have been more disastrous. In other emerging economies capital outflow during the most severe phase of the crisis was considerably lower than in Russia (see Table 1) so the reserves accumulated by Russia proved to be adequate to the existing risks.

Table 1
Foreign sector indicators in certain G20 countries during the crisis

Country	Maximum currency exchange rate fall against US dollar since 1st August 2008 in %	Contraction in international reserves over corresponding period in %	Contraction in international reserves in billion of US dollars	Capital outflow over corresponding period in billion of US dollars
Russia	48	36	212.8	193.0
Republic of Korea	45	19	46.0	42.6
Brazil	60	-2	-3.2	17.1
India	22	19	57.3	11.4

Source: Bank of Russia calculations based on Bloomberg data.

1 *Jeanne (2007): "International reserves in emerging market countries: too much of a good thing?", Brookings Papers on Economic Activity.*
2 *Laeven and Valencia (2008): "Systemic banking crises: a new database", IMF Working Paper, September.*

When the global economic situation is stable, a vast amount of international reserves in the developing countries facilitates the reduction of country risk, reduces the cost of credit for the private sector, making global capital allocation more effective. So, the causes and consequences of global imbalances resulting from the policies of the emerging market countries are complex and controversial.

The United States and some other advanced economies are 'forced' to accept investments as a result of the policies pursued by their trading partners and international investors, who actively invest in their government bonds and private sector debt securities. For example, in the period from 2001 to 2007 foreign investments in US Treasury securities increased by 2.7 times and in US corporate bonds by 3.1 times.[3] However, this 'forced' situation proved extremely comfortable for these countries in the pre-crisis years: while saving very little, they consumed very much, borrowing funds from the whole world at minimum interest rates and placing a part of these funds in the developing countries at much higher rates.

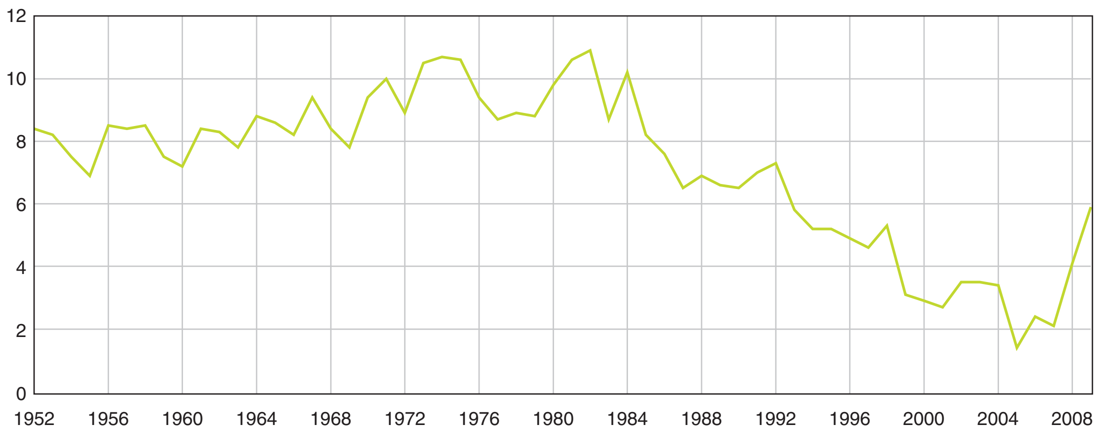
One reason for the sustainability of global imbalances is the imperfect international monetary system, which is largely based on the domination of the US dollar as a reserve currency and lacks adequate instruments of providing global liquidity. The main reserve currency status of the dollar causes the growth of the US double deficit (fiscal and current account), making it easy to finance, and this hinders the reduction of the US structural fiscal deficit. Imbalances increased not only because the IMF had no mechanism to ensure all countries effective access to borrowings from the IMF facilities, but also because there were no tools to force most of the member states to implement IMF recommendations within bilateral and multilateral surveillance.

Thus, the analysis of the causes of global imbalances shows that their growth is a common problem for the developed and developing countries, and should be solved by all nations together.

2| Impact of financial crisis on imbalances in global economy

The disastrous financial crisis has led to the marked contraction of lending in the United States and, as a result, there has been a fall in consumption. US households, having lost access to cheap loans, increased savings. As a consequence, the US personal savings rate (personal savings as a percentage of disposable income) has risen to the highest level since the early 1990s (Chart 1). In the first half of 2010, the public propensity for savings remained unchanged at about 6%. In 2010, the national savings rate, which includes also corporate and government savings, rose as well and the IMF expects in the next five years its moderate growth to the pre-crisis level (Table 2).

Chart 1
US personal savings rate as a percentage of disposable personal income



Source: US Department of Commerce Bureau of Economic Research.

3 *Data on US international investment position. Source: US Department of Commerce.*

Table 2
National savings rate dynamics and outlook for certain G20 countries

(% of GDP)

Country	1995	2000	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Japan	30	28	27	28	28	27	23	23	23	24	24	24	24
United Kingdom	16	15	14	14	16	15	13	12	13	14	15	15	16
United States	16	18	15	16	14	12	11	12	14	15	16	16	16
France	19	21	20	21	21	20	17	18	18	19	19	19	19
Germany	21	20	23	26	29	28	23	25	24	24	23	23	22
Brazil	16	14	19	19	18	17	15	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
China	43	37	51	53	52	52	52	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
India	27	25	34	35	36	34	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Russia	28	36	31	31	31	31	22	26	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: IMF (data and outlook for advanced economies), World Bank, national statistics, Bloomberg.

At the same time, there was a significant contraction in the US current account deficit and a simultaneous reduction in China's current account surplus (Table 3). Thus, initially the crisis somewhat mitigated the existing imbalances but this effect seems to be rather short-term.

In 2010, the developing countries, especially China, have displayed again rapid GDP growth rates, whereas the world's leading economies (the United States, the United Kingdom and the eurozone as a whole) have registered the slowing of economic growth. According to a preliminary estimate as of January 2011, in 2010 China's GDP grew by 10.3%, which represents an increase of 1.1 percentage points in comparison with the same figure of 2009. Beginning from 2012, the US current account deficit will start to increase again, according to the IMF forecast.

The problem of global imbalances may deteriorate further because during the crisis all the leading economies registered significant growth in government debt. The exacerbation of the problem of global imbalances and the increase in the government debt burden may put in question the existence of risk-free assets in the economy and this, in turn, may destabilise the financial system, as the assessment of almost all financial assets is based on the existence of risk-free assets.

The state of the fiscal sector in Russia is better than in other G20 countries and this provides greater potential for the use of stimulating measures, in case there is a need for them, and contributes to financial stability.

The stimulating monetary policy still pursued by the leading industrialised nations will, on the one hand, facilitate the devaluation of their currencies, making their exports more competitive and reducing global imbalances. On the other hand, the injection of vast amounts of liquidity will stimulate the flow of speculative capital to the emerging markets where interest rates are considerably higher, and this will further increase the risk of financial instability, asset price bubbles and an abrupt capital outflow.

Table 3
Current account of certain countries: historical dynamics and IMF forecast

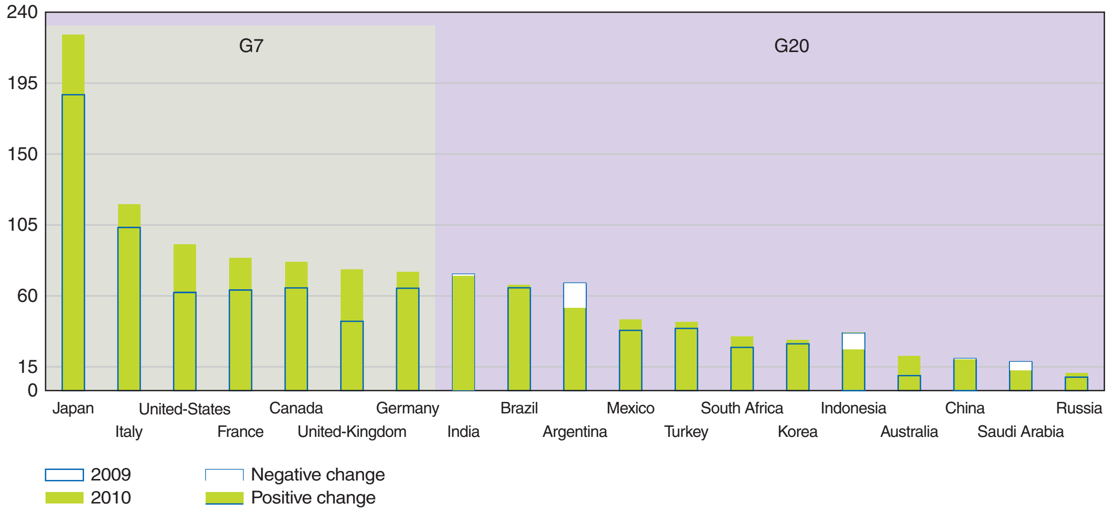
(USD billions)

Country	1995	2000	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Japan	111	120	166	170	211	157	142	166	133	135	130	126	122
United Kingdom	-14	-39	-60	-83	-73	-44	-24	-50	-49	-45	-36	-32	-32
United States	-114	-416	-748	-803	-718	-669	-378	-467	-400	-420	-466	-524	-602
France	7	19	-10	-13	-26	-55	-51	-46	-46	-46	-48	-51	-54
Germany	-30	-33	143	188	254	246	163	200	196	182	173	161	145
Brazil	-18	-24	14	14	2	-28	-24	-52	-65	-77	-81	-84	-92
China	2	21	161	253	372	436	297	270	325	394	494	621	778
India	-6	-5	-10	-9	-8	-25	-36	-44	-50	-54	-53	-53	-53
Russia	7	47	84	94	77	104	50	70	62	47	44	37	33

Source: IMF website, World Economic Outlook Databases, October 2010.

Chart 2
G7 and G20 consolidated government debt: IMF estimate as of end of 2010 and change in 2009-2010

(% of GDP)



Source: Bank of Russia calculations based on IMF data.

In these circumstances many countries with a free capital movement regime are imposing restrictions on foreign capital inflows again. The latest financial crisis provided empirical evidence that in some cases restrictions on the movement of capital may help change the structure of investments (in favour of less risky long-term investments) and avoid the most damaging consequences of the crisis.[4] As a result, the IMF, which had advocated for decades the free movement of capital by countries that had already liberalised their capital account, has now somewhat softened its stance: speaking in Shanghai in October 2010, the IMF Managing Director said that restrictive measures could be used in some cases when capital inflows may have a destabilising effect.

It should be noted that the range of possible measures aimed at containing capital inflow may be quite wide and include various administrative and market instruments and instruments of prudential regulation, which are designed to increase the stability of the financial institutions and affect the inflow of foreign capital indirectly. For example, in October 2010 Thailand imposed a 15% tax on income from government bonds paid to foreign investors and Brazil levied a tax on foreign investment (differentiated tax rates were set on the shares of Brazilian companies, bonds of Brazilian issuers, etc). As for the measures announced by South Korea last June, their principal objective was to contain growth in banking sector foreign liabilities. These prudential measures include a limit on the currency derivatives position, a restriction on foreign currency-denominated loans extended by banks and higher liquidity requirements for the Korean banks' assets denominated in foreign currency.

Russia removed all restrictions on the movement of capital in 2006 and it has no plans to reinstate them. We believe that some regulatory measures aimed at maintaining stability of the financial sector, containing excessive lending and preventing asset price bubbles may be useful under certain circumstances. However, by and large, Russia remains committed to the principles of the capital flow liberalisation and this, in our opinion, is the right approach from the viewpoint of the long-term improvement of the investment climate.

On the whole, Russia managed to protect itself from the most destructive consequences of the capital outflow during the crisis. When export revenues grew as a result of the rise in oil prices and the Russian economy was infused with an unprecedented amount of foreign capital, the Bank of Russia and the Russian Government accumulated significant reserves and

4 *Ostry* et al. *(2010): "Capital inflows: the role of controls", IMF Staff Position Note, February 19.*

created stabilisation funds, which protected the economy from capital losses when private investors panicked. No new restrictions were imposed on capital inflow or capital outflow.

There is no doubt that reserves and stabilisation funds are extremely important weapons in fighting the crisis, but they are not enough. Experience has shown that even vast reserves may not be sufficient to maintain stability on the foreign exchange market at the height of an acute crisis when these reserves are spent up quickly because of the worsening expectations and herding behaviour. Therefore, the policy of accumulating reserves and funds should be backed up by other measures, including macroeconomic ones and policy co-ordination with trading partners.

3| Measures to mitigate global imbalances and assist financial stability

An exchange rate policy readjustment by some emerging economies and G20 countries' refusal to participate in 'currency wars' are important steps in tackling the problem of global imbalances, but these are not enough. It is necessary further to raise the savings rate in the industrialised nations on the basis of large-scale structural reforms. The projected measures to cut budget deficits in most of these countries, the reforms of the pension, education and healthcare systems and the abolition of excessive subsidies in some sectors will help these countries optimise expenditures in their economies and preserve the achieved economic growth rates on the basis of the maximum use of their internal resources while restricting the growth in foreign debt.

On the other hand, it is extremely important for the emerging economies to stimulate domestic consumption. The impressive national savings rate in China (about 52% of GDP in 2009) and its rapid growth (from 37% of GDP in 1999) is based on its world's highest savings rates in all sectors –government, corporate and household. These levels were achieved, in part, owing to tempestuous economic growth rates and, in part, they were the upshot of some institutional and demographic factors (the restructuring of state companies, the transition to the pre-funded pension system and the significant expansion of the share of the working-age population), whose effect will abate in the future. The state sector, whose savings made the biggest contribution to the rise in the savings rate in China, is expected to increase spending on social programmes.

In its consultation reports within the framework of Article IV, the IMF notes that in order to reorient its economy to growth in domestic consumption, China should, in addition to increasing social transfers and implementing structural reforms in the corporate sector, allow the renminbi's appreciation, which will increase private sector consumption. It is clear that China is facing a dilemma: letting the currency get too strong seems dangerous because in that case the country may lose its competitive advantage, while the refusal to strengthen the exchange rate is fraught with the risk of overheating the economy.

To resolve the problem of global imbalances, the international community should also address the problem connected with the accumulation of reserves by developing countries for the purpose of creating a buffer reserve. More rapid rates of growth in these countries create objective conditions for the inflow of foreign capital. But reserves are necessary as a safeguard against a possible sharp capital outflow. The development of a global financial safety net in the future will help reduce countries' needs in gold and foreign exchange reserves. The further improvement of IMF instruments, especially the Flexible Credit Line and Precautionary Credit Line, will play a major role. These mechanisms should be accessible for the countries with a sound macroeconomic and financial regulation policy, which nevertheless suffer from high financial account volatility. It is important in this case to ensure that the use of these instruments does not become a distress signal in regard to the countries applying for the IMF credit lines. On the contrary, they should serve to bolster investor confidence and stabilise the situation.

To assist financial stability in the emerging economies, it is needed to make carry trade and other speculative investments less attractive and take steps to increase the share of long-term investments. Making speculative investments in rouble assets less attractive by ensuring a more flexible rouble exchange rate is one of the measures being carried out in Russia at present. Measures to strengthen the financial system and improve regulatory rules will contribute to minimising the risk of a double crisis, when the outflow of foreign capital provokes residents to actively withdraw funds from the financial system. In addition, Russia, like other emerging economies, must stimulate the development of stable internal sources of growth in the real economy.

Obviously, global imbalances cannot be eliminated overnight and the world economy will still face this problem for a time. However, we must not allow imbalances to grow to such an extent that international relations will be thrown back to the time of currency wars and protectionism. To prevent such a development is the joint responsibility of both the countries with a current account deficit and countries with a current account surplus. Meanwhile, the best long-term solution to the problem of imbalances would be for both the developed and developing countries to ensure a more balanced correlation between national savings and investments by carrying out the necessary structural reforms. At the same time, it is clear that an open global economy, free international financial markets and a more effective and equitable international monetary system should constantly assist the international community in attaining these goals.